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The Manufacturers Hanover
Economic Report

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What Went Wrong?

As 1980 drew to a close, the U.S. economy found itself in the throes of its second credit crunch in twelve months—an unprecedented development in modern times. The yield curve turned steeply negative, disintermediation once again struck the nation's thrift institutions, many firms stepped up their demands for short-term credit, while at the same time a number of others found themselves unable to borrow because of steeply rising money costs.

Clearly, this development has significant implications for the 1981 business outlook. As 1980's first credit crunch demonstrated, there never has been a time in modern economic history when a credit crunch has developed and the economy has not gone into recession. Coming so soon after 1980's earlier slump, this downturn is striking before many individuals and businesses have had an opportunity to restore their balance sheets to a better state of health.

I do not intend to dwell on the business outlook in this issue. That will be taken up in more detail next month, following the release of the fourth quarter's data on the gross national product. What I would like to discuss this month is why such a credit squeeze is occurring. It certainly can not be the goal of monetary policy to produce repeated liquidity squeezes—especially as close together as the current one is to its predecessor. To say that interest rates are high because inflation expectations are high misses the point, since it should be the goal of monetary policy to reduce inflation pressures in order to promote a healthier economy. Of course, I recognize that when the government is running budget deficits of the size and frequency recorded in recent years, it becomes extremely difficult for monetary policy to avoid creating periodic bouts of high interest rates, high inflation expectations or both. Still, as my November Economic Report observed, budget deficits are nothing new to the U.S. economy. Credit squeezes, however, are: The first postwar credit squeeze didn't begin until 1966, and since then we have had four more, including the current one.

One reason why I think that interest rates have reached the heights that they have has to do with changes in government policy. It used to be that tight money impacted new-home construction fairly quickly, thus slowing the economy because housing is the nation's single largest industry with many others dependent on it. But the booms and busts that occurred in housing after World War II led to pressures to modify these effects, since they were producing a shortage of dwellings relative to potential demand, pricing a growing number of families out of the market.

As a consequence, Federal regulations regarding interest rates that thrift institutions could pay were changed. To the extent that the thrifts (which provide the bulk of the funds for residential mortgages) have been able to pay money market interest rates to attract deposits, they have retained an ability to lend for new-home construction and purchasing that they did not have before. Thus a given level of interest rates (nominal or real, for that matter) does not have the effect on the economy that it used to because of the "sheltering" of the housing market. Not surprisingly, interest rates have had to go higher, before affecting new-home construction—producing crunch conditions elsewhere.

The Role Of The Discount Rate

But this is only one part of the problem. I believe that there are some flaws in the way the Federal Reserve conducts monetary policy. Perhaps the most serious is the Federal Reserve's policy of establishing a fixed discount rate. As many of you undoubtedly know, the rate that the Federal Reserve charges member banks when they come to its discount window to borrow is basically fixed. That is—it does not fluctuate as do money market rates, but rather, remains at a given level for a considerable period of time. We learned in school that the Fed uses a change in the discount rate to achieve maximum publicity whenever it tightens or loosens monetary policy. In addition, the fact that some banks do go to the discount window to borrow offers the Fed an opportunity to "police" their lending activities. The Fed also views the discount window as a sort of

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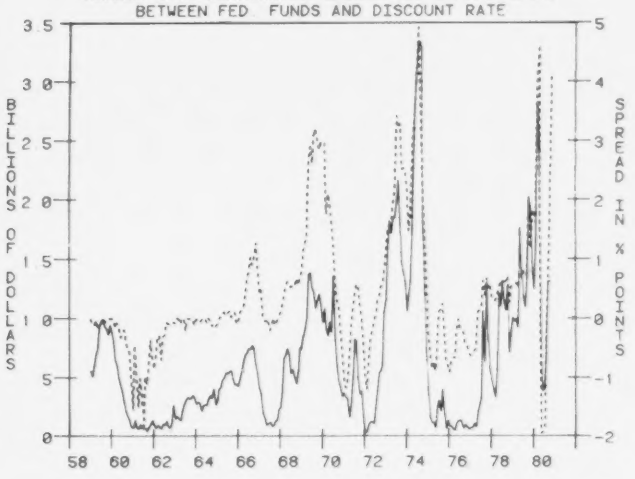
safety valve, allowing some of the pressures that might develop in the financial system during periods of extremely tight money to be vented.

CHART I
MEMBER BANK BORROWINGS (LINE) VS SPREAD (DOT)
BETWEEN FED FUNDS AND DISCOUNT RATE



I think what the Federal Reserve's fixed discount rate is doing is causing changes in member bank borrowing that the Fed can not control. As you can see from Chart I, there is a pretty good relationship between the trend in member bank borrowings from the Federal Reserve and the difference between the Federal funds rate and the Fed's discount rate. When this spread is large, member bank borrowings tend to be large; vice versa when the spread is low. It is clear that one of the main reasons why banks borrow at the discount window is that it is cheaper than borrowing from other banks at money market rates. Ironically, the tighter the Federal Reserve thinks monetary policy is getting (when it pushes up money market rates), the easier policy may actually be, since the greater are member bank borrowings.

It might be interesting to note that the Reichsbank, in post-World War I Germany, also had a policy of pegging the discount rate at a level far below money market rates. At one point during that country's bout with hyperinflation, the discount rate was 90 per cent when the market rate of interest on bank loans was more than 7,300 per cent per year. As the Federal Reserve Bank of Richmond recently observed, "This huge interest differential made it extremely profitable for banks to rediscount bills with the Reichsbank and then to loan out the proceeds, thereby producing additional inflationary expansions of the money supply and further upward pressure on interest rates."

If the discount rate were allowed to float rather than be fixed, things might be different. The Fed could have the discount rate float at a constant level relative to the Federal funds rate—perhaps some 50 basis points higher. Were this to happen, member bank borrowing would become far more predictable since the margin between the cost of funds at the discount window and the return on these funds would be constant. It would follow that the Fed's ability to control the money supply would be aided.

Interest Rate Concerns

Another problem with operating procedures is that the Federal Reserve has continued to look at interest rates—even under the new regime begun over a year ago of concentrating on control of the monetary aggregates. Economists have argued for the longest time that attempting to manage the monetary system by jiggling short-term interest rates was self-defeating, so we were glad to note the Fed's announcement of October 6, 1979 that it was going to move away from these interest rate-oriented operating procedures.

In actual fact, however, the Fed still pays close attention to interest rates. Quoting from a recent statement by Federal Reserve Chairman Paul Volcker: "We have...emphasized the limitations of using interest rates as a reliable indicator of the thrust of monetary policy. Nonetheless, we had to recognize that, even against the backdrop of a declining money stock, the already precipitous decline in interest rates might be misread as a fundamental reversal of policy—a lessening of our resolve to fight inflation." Further proof that the Fed is still overly concerned about interest rates and continues to use them relatively frequently as a guide to determining whether it should add or drain reserves from the banking network can be seen from a glance at the Board's operating instructions to the money desk of the Federal Reserve Bank of New York. They continue to contain target ranges for the key Federal funds rate—the only difference now is that the range is much broader than it used to be.

Underlying the use of a Fed funds target as the principal instrument of monetary policy execution is the notion that at some level the cost of borrowing money will inhibit borrowing, and at the same time, encourage the substitution of short-term interest-earning investments for cash. But, as can be seen from the current surge of business loan demand in the face of record-high interest rates, the cost of credit alone has little immediate influence on its demands. And if the demand for credit is strong and credit is available, then the Fed's policy of slowing the money and credit aggregates will not be successful.

From here, it would seem that credit availability, rather than credit cost, should be the objective of Fed policy. This can be achieved by a monetary policy that regulates what might be called the bottom line: i.e. the supply of bank reserves. The target statistic might be the monetary base, which could serve as a rough proxy for bank reserve availability. When the Fed begins to focus exclusively on the monetary aggregates and allows interest rates to be

determined by supply and demand in the market, then the Fed will have better control over monetary policy.

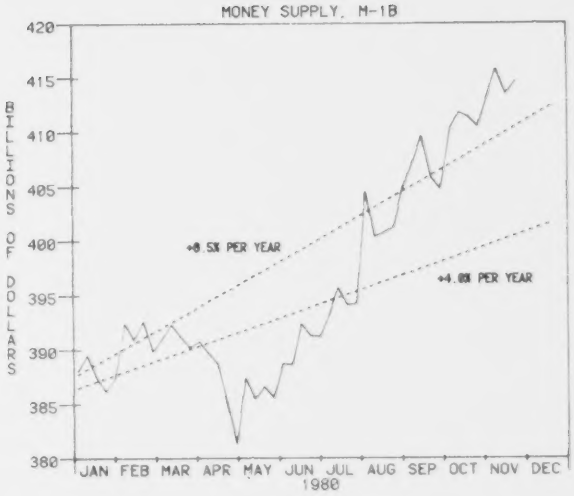
You will notice I did not say "control over the money supply." This may happen in time—but only after there is general agreement on just what is money. The definition of money keeps changing because of changes in regulations and technology and because of the innovativeness of the private sector. In an effort to capture the real-world byproducts of these developments, the Fed redefined money earlier this year. Thinking it could separate transactions from savings-type accounts, the Fed changed M-1 into M-1A (currency plus demand deposits) and M-1B (M-1A plus other checkables at banks and thrift institutions). Definitions for the other Ms were changed as well, and an all-encompassing L (for total liquidity) was introduced. Unfortunately, these definitions were nothing more than an admission of definitional shortcomings of the past and an attempt to catch up with developments that probably changed by the time these new concepts were introduced. Needless to say, the development of nationwide NOW accounts beginning January 1, along with the gradual elimination of interest ceilings on time deposits—not to mention continued innovativeness in the private sector—will continue to blur definitions of money.

Too Much Publicity

One additional cause for instability in the marketplace stems from the publicity surrounding the Fed's actions. To be sure, the Fed does not release the minutes of its policy decisions taken by the FOMC for at least one month. However, release of weekly statistics on the money supply, juxtaposed with monthly, quarterly and annual target ranges, has caused people to pay an undue amount of attention to these weekly data, which are, by and large, statistically unsound. Any weekly number tends to be mostly influenced by random events and contains a lot of statistical noise, and the money supply is no exception. Yet, because the Fed has announced annual targets, it is tempting for the markets to plot the weekly levels of the money supply and compare it with the Fed's target range.

The Fed announced earlier this year that it would like the money supply M-1B to grow at a compound rate of growth between four per cent and 6½ per cent from fourth-quarter 1979 to fourth-quarter 1980. Chart II depicts the target band described by these growth paths. Early in 1980 the money supply was growing within its assigned target range, but then it fell far below it as the economy nose-dived in the second quarter. It was not the cost of money that caused the economy to decline. Rather, it was its availability (or people's perception of its availability, since the Federal Reserve imposed credit controls, which were widely misunderstood). People came to believe that credit was not available, so they cut

CHART II
MONEY SUPPLY, M-1B



back their purchasing of big-ticket items, causing the economy to drop in the second quarter by a record annual rate of 9.6 per cent.

Once the Fed realized what was happening and lifted these controls, activity bounced back and with it the money supply. By July, the money supply was back in its target band—only to jump above it in September. The fact that the money supply remained above its growth target through yearend caused the markets to anticipate that the Fed will tighten further in order to drain reserves from the banking system and slow money's growth. These efforts to anticipate the Fed's operating tactics contributed to monetary instability, producing the latest credit squeeze.

Recommendations

As it seeks to regain control over the monetary aggregates, the Fed might want to consider making some changes in its operating procedures. Plainly, the Fed should institute a floating discount rate, thus removing what I would consider a major leak in the system. In addition, the Fed should pay less attention to money market interest rates—if it bothers with them at all. I don't think that the Fed should issue weekly money supply data, but if it must, it should provide better information on just what exactly money is and how its various holders and users view it. Certainly, the Fed should not release its interim (monthly and quarterly) "fine-tuning" targets, since these are merely guidelines to help the Fed make mid-course corrections in order to achieve its annual goals and are not inviolate in any given week or month, so long as they are achieved.

Most of all, I think the Fed should turn down the glare of the spotlight and put a little mystery back into its activities. Not only would this cut down on Fed-watching and the markets' tendencies to jump to conclusions—it might make monetary policy a little more interesting and the economy a little less unstable. H

Season's Greetings

...and a HAPPY NEW YEAR to all!

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